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Related party transactions; Statement on auditing standards, 006

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

Statement on Auditing Standards

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AICPA American Institute of Certified Public Accountants

Related Party Transactions

1. This Statement provides guidance on procedures that should be considered by the auditor when he is performing an examination of financial statements in accordance with generally accepted auditing standards to identify related party transactions and to satisfy himself as to the substance of and accounting for such transactions, including financial statement disclosure.[1] The procedures set forth herein should not be considered all-inclusive. Also, not all of them may be required in every examination.

2. For purposes of this Statement, the term *related parties* means the reporting entity; its affiliates;[2] principal owners, management, and members of their immediate families;[3] entities for which investments

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[1]When financial statements are presented on a consolidated or combined basis, this Statement does not apply to transactions that are eliminated in the preparation of the financial statements.

[2]The term *affiliate* means a party that directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, a specified party. *Control* means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a specified party whether through ownership, by contract, or otherwise.

[3]The term *principal owner* means the owner(s) of record or known beneficial owner(s) of more than 10% of the voting interests of the reporting entity. The term *management* means any person(s) having responsibility for achieving the objectives of the organization and the concomitant authority to establish the policies and make the decisions by which such objectives are to be pursued. It would normally include members of the board of directors, the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration, or finance), and any other individual person who performs similar policy making functions.

are accounted for by the equity method; and any other party with which the reporting entity may deal when one party has the ability to significantly influence the management or operating policies of the other, to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Related parties also exist when another entity has the ability to significantly influence the management or operating policies of the transacting parties or when another entity has an ownership interest in one of the transacting parties and the ability to significantly influence the other, to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

3. Examples of related party transactions include transactions between a parent company and its subsidiaries, transactions between or among subsidiaries of a common parent, and transactions in which the reporting entity participates with other affiliated businesses, with management[4] or with principal stockholders (or other ownership interests). Transactions between or among the foregoing parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an entity may provide services to a related party without charge.

4. Sometimes two or more entities are under common ownership or management control, but they do not transact business between or among themselves. Mere existence of common control, however, may result in operating results or financial position significantly different from those that would have been obtained if the entities were autonomous. For example, two or more entities in the same line of business may be commonly controlled by a party with the ability to increase or decrease the volume of business done by each. Consequently, the nature of the common control should be disclosed.

5. An entity may be economically dependent on one or more parties with which it transacts a significant volume of business, such as a sole or major customer, supplier, franchisor, franchisee, distributor, general agent, borrower, or lender. Such parties should not be considered related parties solely by virtue of economic dependency unless one of them clearly exercises significant management or ownership influence over the other. Disclosure of economic dependency

[4]Compensation arrangements, expense allowances, and other similar items in the ordinary course of business are not deemed to be related party transactions for purposes of this Statement.

may, however, be necessary for a fair presentation of financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles.

Accounting Considerations

6. Except for the disclosure requirements of the Securities and Exchange Commission's Regulation S-X and the accounting treatment prescribed by certain Opinions of the Accounting Principles Board when related parties are involved, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. Until such time as applicable accounting principles are established by appropriate authoritative bodies, the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure of the existence of such transactions and their significance in the financial statements of the reporting entity. He should be aware that the substance of a particular transaction could be significantly different from its form.[5]

7. Generally, financial statements should recognize the economic substance of transactions rather than merely their legal form. Accounting Principles Board Statement No. 4, paragraph 35, states: "Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form."

8. Examples of transactions that raise questions as to their sub-

[5]The importance of recognizing substance, when it differs from form, of various transactions and presentations has been established in authoritative pronouncements. Those pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (a) presenting consolidated financial statements instead of separate statements of the component legal entities (ARB No. 51); (b) capitalizing leases (APB Opinion No. 5); and (c) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange therefor (APB Opinion No. 21).

stance and that may be indicative of the existence of related parties are the following:

a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below current market rates.

b. Selling real estate at a price that differs significantly from its appraised value.

c. Exchanging property for similar property in a nonmonetary transaction.

d. Making loans with no scheduled terms as to when or how the funds will be repaid.

Audit Procedures

9. An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his examination, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements. Many of the procedures outlined in the following paragraphs are normally performed in an examination in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions exist. Other audit procedures set forth herein are specifically directed to related party transactions.

10. In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should evaluate internal accounting controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.

11. In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary

course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

a. Lack of sufficient working capital or credit to continue the business.

b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock.

c. An overly optimistic earnings forecast.

d. Dependence on a single or relatively few products, customers, or transactions for the ongoing success of the venture.

e. A declining industry characterized by a large number of business failures.

f. Excess capacity.

g. Significant litigation, especially litigation between stockholders and management.

h. Significant obsolescence dangers because the company is in a high-technology industry.

Determining the Existence of Related Parties

12. The auditor should place emphasis on auditing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures which may include the following:

a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.

b. Inquire of appropriate management personnel as to the names of all related parties and whether there were any transactions with these parties during the period.

c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.

d. Determine the names of all pension and other trusts established for the benefit of employees and the names of the officers and trustees thereof.[6]

e. Review stockholder listings of closely held companies to identify principal stockholders.

f. Review prior years' workpapers for the names of known related parties.

g. Inquire of predecessor, principal, or other auditors of related entities as to their knowledge of existing relationships and the extent of management involvement in material transactions.

h. Review material investment transactions during the period under examination to determine whether the nature and extent of investments during the period create related parties.

Identifying Transactions With Related Parties

13. The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

a. Provide audit personnel performing segments of the examination or examining and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their examinations.

b. Review the minutes of meetings of the board of directors and executive or operating committees for information as to material transactions authorized or discussed at their meetings.

c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information as to material transactions with related parties.

d. Review "conflict-of-interests" statements obtained by the company from its management.[7]

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[6] If the trusts are managed by or under the trusteeship of management, they should be deemed to be related parties for purposes of this Statement.

[7] Conflict-of-interests statements are intended to provide the board of directors with information as to the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business.

e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management, or other services at no charge or a major stockholder absorbing corporate expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.

i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Examining Identified Related Party Transactions

14. After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction as to the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[8]

b. Examine invoices, executed copies of agreements, contracts, and

[8]Until the auditor understands the business sense of material transactions, he cannot complete his examination. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

other pertinent documents, such as receiving reports and shipping documents.

c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.

d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.

e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with an appropriate exchange of relevant information.

f. Inspect or confirm and obtain satisfaction as to the transferability and value of collateral.

15. When necessary to fully understand a particular transaction, the following procedures which might not otherwise be deemed necessary to comply with generally accepted auditing standards should be considered:[9]

a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.

b. Inspect evidence in possession of the other party or parties to the transaction.

c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.

d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.

e. With respect to material uncollected balances, guarantees, and other obligations, obtain information as to the financial capability of the other party or parties to the transaction. Such information

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[9]Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Disclosure

16. To satisfy himself as to the adequacy of disclosure with respect to a specific related party transaction, the auditor should determine whether he has obtained sufficient competent evidential matter to enable him to understand the relationship of the parties, the substance of the transaction, which may differ from its form, and the effects of the transaction on the financial statements. He should then evaluate all the information available to him with respect to the transaction and satisfy himself on the basis of his professional judgment that the transaction is adequately disclosed in the financial statements (see section 430.02 of Statement on Auditing Standards No. 1).

17. Disclosure in financial statements of a reporting entity that has participated in related party transactions that are material, individually or in the aggregate, should include the following:

a. The nature of the relationship(s).

b. A description of the transactions (summarized when appropriate) for the period reported on, including amounts, if any, and such other information as is deemed necessary to an understanding of the effects on the financial statements.

c. The dollar volume of transactions and the effects of any change in the method of establishing terms from that used in the preceding period.

d. Amounts due from or to related parties and, if not otherwise apparent, the terms and manner of settlement.

18. Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or, assuming it would have taken place, what the terms and manner of settlement would have

been. Accordingly, representations to the effect that a transaction was consummated on terms no less favorable than those that would have been obtained if the transaction had been with an unrelated party are difficult to substantiate. If such a representation is included in the financial statements and the auditor is unable to reach a conclusion as to the propriety thereof, he should consider including in his report a comment to that effect and expressing a qualified opinion or disclaiming an opinion (see SAS No. 2, paragraphs 10–12). If he believes that the representation is misleading, the auditor should express a qualified or adverse opinion, depending on materiality (see SAS No. 2, paragraphs 15 and 16).

Effective Date

19. Statements on Auditing Standards generally are effective at the time of their issuance. Since this Statement, however, provides for practices that may differ in certain respects from practices heretofore considered acceptable, this Statement will be effective for examinations of financial statements for periods ending on or subsequent to December 26, 1975.

The Statement entitled "Related Party Transactions" was adopted unanimously by the twenty-one members of the Committee, of whom two, Messrs. Goble and Silverman, assented with qualifications.

Mr. Goble approves issuance of this Statement but qualifies his assent with respect to paragraph 18 because it suggests that the auditor will rarely be able to determine whether related party transactions are on a basis equivalent to that which would have occurred absent the relationship. He believes many related party transactions are subject to an "equivalence" comparison and, whenever practicable, the auditor should make such a comparison. If the auditor concludes that a related party transaction was recorded on a basis different from that which would have been appropriate for an equivalent arm's-length transaction, he should issue a qualified opinion. The explanatory paragraph would state that, although the financial statements reflect what happened, the results would have been different if the transaction had been made on an arm's-length basis. If the auditor cannot make such a comparison he need not qualify his opinion, but he should include an explanatory paragraph which would explain that a comparison is not practicable.

Mr. Silverman approves issuance of the Statement but qualifies his assent with respect to paragraph 18. He believes it would not be possible to determine whether a particular transaction between related parties would have taken place if the parties had not been related or, assuming it would have taken place, what the terms and manner of settlement would have been. Thus, a test of "equivalence" is unfeasible. If it is represented in financial statements that such determinations have been made, the representations should be marked as unaudited and they should have no effect on the auditor's opinion. Such representations are not required by generally accepted accounting principles, and therefore paragraphs 15 and 16 of SAS No. 2 would not apply to them.

Auditing Standards Executive Committee (1974-1975)

Note: *Statements on Auditing Standards are issued by the Auditing Standards Executive Committee, the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards, and requires that members be prepared to justify departures from such Statements.*